197345

INDEPENDENT FOREST PRODUCTS ASSOCIATION

"Advancing small businesses and stable communities."

Testimony Before

The

Surface Transportation Board

Regarding

Major Railroad Consolidation

And the

Structure of the North American Railroad Industry

(STB Ex Parte No 582)

Presented by

Frank M. Gladics
Independent Forest Products Association

March 9, 2000

14780 S.W. Osprey Drive Suite 270 Beaverton, Oregon 97007 (503)590.5559 Fax (503)590.1555

Madam Chairman and Board, for the record my name is Frank M. Gladics. I am the President of the Independent Forest Products Association (IFPA), a forest products trade organization representing over fifty forest product manufacturers and landowners in Alaska, Washington, Oregon, California, Idaho, Montana, Wyoming, Arizona, Minnesota, Michigan and Wisconsin. IFPA represents small family owned operations in these states.

IFPA commends the Surface Transportation Board (STB) for initiating this review of major railroad consolidations and the present and future structure of the North American railroad industry. Without any further consolidation activity among the remaining rail carriers, these issues would continue to be of tremendous concern to our members who utilize the rail system. The December announcement that Burlington Northern and Santa Fe Railway (BNSF) and Canadian National Railways (CN) intend to merge has raised the stakes. The subsequent reactions from other Class I railroads and from this Board make it very clear that the next merger to be approved—regardless of the merger partners—will inevitably cause a domino effect, the outcome being—at the most—a two-railroad system throughout North America, with extension of each system's monopoly power over that which is exercised today.

That is a frightening proposition considering that in today's system of two major eastern and two major western railroads, there is little true competition among carriers for a significant portion of their business and that economic regulation has not been sufficiently revised to compensate for what has become an exponentially increasing competitive void. In fact, for many of IFPA's members there already is no competition and our service has already suffered. No major merger—whether it's the proposed BNSF-CN merger or two other Class I carriers—should be considered without system-wide changes to rail policy that would address what has now become an extensive record of customer complaints and widespread dissatisfaction. In other words, merger conditions that apply only to the merging carriers will not address the breadth of concern, and would most likely put one carrier at a significant disadvantage to the few remaining carriers.

Most of our members rely on railroads to transport a portion of their finished products to market. Some are located where they rely solely on Class 1 railroads for their shipping needs. Others utilize short lines to connect with Class 1, while some truck their products to a reload usually located on a Class 1. On average, transportation costs are between 10 and 25 percent of sales value and is the third highest cost of production. While the total tonnage of forest products relying on rail is large, unlike coal and grain, our industry has many producers and even more customers who receive the freight. This fact makes our situation somewhat unique and highly vulnerable to changes in the railroad structure.

Consequently, any changes in the existing railroad system would have a direct impact on our members businesses and for that reason I am here to present IFPA's concerns regarding the subject of major railroad consolidations and the present and future structure of the North American railroad industry.

There are three major areas of concern that I would like to address to the Board, which are: (1) The forest products industry cannot afford anymore service disruptions or difficulties like those experienced in the last round of major railroad mergers; (2) Any changes in the North American railroad structure should be both market and trade neutral; (3) Any future changes in the North American railroad structure should result in an increased level of competition among the railroads and not further situations that will negatively affect rates paid by shippers.

Recent Mergers Have Negatively Affected Service

Historically, IFPA has focused its efforts on forest policy and regulatory issues at the federal level, since 1997 we have been forced to became involved with railroad transportation issues due to our member's difficulties resulting from the Burlington Northern/Santa Fe and Union Pacific/Southern Pacific mergers. When it comes to rail issues the Northwest Forestry Association has provided key leadership within the Western lumber industry and many of our comments reflect NFA's concerns. IFPA has lent our support to the Northwest Forestry Association over the last four years and appreciates that organizations leadership on this issue. Many of IFPA's members also belong to NFA.

Forest product manufacturers from across the West began complaining of poor service and came to us with horror stories of two major rail companies failure to provide a reliable means of transporting their products to the marketplace. While service has improved, it is still not to a level that our members had come to expect prior to the merger.

While the Burlington Northern/Santa Fe's service history is somewhat better than Union Pacific's, our members continue to have problems with consistent and timely service.

These types of service difficulties and disruptions have a direct affect on our members' profitability. An inability to have a reliable means to transport their goods to the customer means higher costs and/or lost opportunities. Unfortunately, some of our members are still recovering from the impact of the last round of railroad mergers. While market share that was lost may return, the financial losses suffered can never be recovered.

Our ability to compete in the forest products marketplace should not be held hostage by incompatible computer systems resulting from mergers. Simply put, the West's forest products industry cannot afford anymore railroad mergers until shippers are receiving an acceptable level of service and are provided a guarantee that includes a form of measurement and remedy to the shippers.

According to the Alliance for Rail Competition (ARC) the merger of the Burlington Northern (BN) and Santa Fe (SF) railroads in mid-1995 was based on projected annual savings of $450 million in operating and administrative expenses, and the realization of another $110 million in operating income on new revenue to be earned. After increasing its offer for the SF from $2.6 billion to just over $4.0 billion, BN reiterated the advantages of the merger which included: single-line service to all four major West Coast ports; the merging of Santa Fe's market strength in intermodal with BN's coal, grain and commodities traffic; and, administration efficiencies that will, among other things, allow the elimination of some 2,750 jobs. At the same time, BNSF was saddled with significant new debt that ultimately would have to be passed on to customers. The experience of our members has been that BNSF's service has not improved to the levels we enjoyed prior to the merger and at times has been very problematic. The BNSF's conversion to a computerized car distribution system is one example where customers were left without the cars they needed and suffered as the BN and SF attempted to marry two different computer systems together.

More recently the BNSF has proposed to allow brokers to bid on lumber cars. They claim it will make their system of contracting cars to shippers more transparent, but it will also invite a new competitor into the system who could purchase the rights to all the cars and then turn around and charge astronomical prices to smaller companies who must find the rail cars they need to ship their lumber. In short, the jury is still out on the BNSF's latest proposal and we will see if their cobbled-together computer system will effectively deal with the new method of car distribution.

Future Mergers Should Not Affect International Trade Agreements

There are rumors that the BNSF has requested that the Surface Transportation Board not examine Canadian domestic rail rates as part of its deliberations on the BNSF proposed merger with the Canadian National Railroad (CN). This would be a serious mistake that could have significant impacts on the Canadian Lumber Agreement. If approved the merger between the BNSF and CN would increase the number of access points that Canadian lumber companies have into the United States. There are persistent rumors that the CN has been telling Canadian shippers that the merger will make Canadian companies more competitive in regards to shipping Canadian lumber into the United States.

While the Canadian Lumber Agreement is not the concern of the Surface Transportation Board, IFPA believes the Board must be mindful of how its actions might affect that Agreement, as well as other international trade agreements. As such, we believe all merger proposals must examine rail pricing on both sides of any international border with the United States.

One of the complaints which drove the United States and Canadian governments to sign the Canadian Lumber Agreement was the strong evidence that the Canadian Government subsidizes Canadian timber purchased by Canadian companies. Transportation can play a roll in a government's efforts to subsidize its domestic industries and as such must be examined.

Suppose the BNSF/CN merger is approved and two identical loads of lumber leave British Columbia and Oregon at the same time and suppose the lumber on the CN stays in Canada until it reaches Quebec. And then it is shipped into the United States through a CN and CSX inter-connection and suppose the CN charged 15% less to ship that car of lumber across Canada, as compared to what the BNSF charged the Oregon lumber mill to ship their car of lumber from Oregon to say New York through a CSX connection. When the Canadian lumber comes across the border it would have a competitive advantage over the lumber from Oregon. If the Surface Transportation Board fails to examine domestic rail rates within Canada, and the CN chooses to subsidize lumber shipments across Canada, the Board will have done a great disservice to American companies.

The wood and paper products industry is a highly competitive sector of our nation's economy. Nation-wide there are several thousand producers with annual sales totaling approximately $200 billion. Products are shipped around the continent and the world, competing with products produced in the consumer's own local area. Therefore, since the forest products industry is so competitive, we cannot afford market externalities such as a railroad merger to affect individual producers access to markets.

Like domestic markets, international trade is another area where railroad mergers could have a significant affect on individual companies' businesses. International trade is an important aspect of our nation's economy. Unfortunately, trade relationships and agreements are usually more politics than economics and such is the case with forest products. For this reason, the Board should be wary of any decisions that may have international trade implications and that could have negative consequences on domestic producers.

IFPA members feel that the STB should employ a simple test for evaluating any proposed change in the North American railroad structure, which is, all proposals should be market and trade neutral -- that is not benefiting one county's producers over another.

Competition and Savings

Like every large public service sector business the people of North America have voiced concerns regarding railroad monopolies and competition almost from the first day railroads began to be built. While mergers and consolidations in the business world promote corporate efficiencies, railroads have large fixed capital assets that prevent free market principles from operating ideally. This is one of the main reasons why the federal government regulates railroads and why there is a Surface Transportation Board.

Simply put, IFPA's members are concerned that any additional mergers would lead to less competition among the railroads and result in increased shipping rates. Without competition, the benefits of mergers, such as increased efficiencies, will not occur and instead mergers will lead to stagnation, complacency and disrepair. There needs to be a "critical mass" of service providers or there may be a need for additional regulations.

The approval of another major Class 1 railroad merger will result in the other major railroads attempting to forge their own deals and win STB approval. This process would ultimately lead to a North American railroad structure with a single transcontinental line. Shippers would be at the mercy of the monopoly and ultimately the nation's railroad system could collapse due to competition from transportation alternatives such as trucks, barges and container ships. We suggest the Board take the time to re-read the book *Atlas Shrugged* by Ayn Rand, while only a novel, it does help one understand the importance of a viable competitive railroad system in the United States.

IFPA and its members believe the STB must evaluate proposed mergers on the basis of whether they are in the public's interest and not whether they are in the interests of the railroads and their investors. A case in point is the Union Pacific/Southern Pacific merger approved by the STB the Southern Pacific was in financial trouble and disrepair. The merger with Union Pacific and the influx of new capital saved the railroad. Therefore this merger benefited the public's interest and generally maintained healthy competition.

We believe the purpose of economic regulation is to control an industry in such a way that its behavior will resemble that of a competitive industry. Something is wrong with railroad regulation when the service deficiencies which have been documented over the past five years or so, following large mergers of Class I railroads, are allowed to occur. Furthermore, in competitive industries the individual companies do not price similar services so that they make an infinitesimal margin on some business while pricing other business at more than twice the level of costs. This is not to say that differential pricing is not practiced by virtually all businesses in the United States, but rather to suggest that the span of profit margins in the railroad industry is much wider than in industries in competitive markets.

What is of major concern to our members is that the railroad mergers were supposed to correct service deficiencies, rather than exacerbate them. Yet, we hear from railroad executives that the service problems are to be blamed on satiated yards and terminals. But, isn't this a railroad management problem. After all, consider the cost savings enjoyed by railroads as shown in the attached table from ARC (table 1). Railroad unit costs have declined dramatically over the past 60 years. Even since 1980, as Table No. 1 shows, "real" (constant-dollar) costs have declined by 63% from 5.32 cents per ton-mile to 1.98 cents per ton-mile. At the same time, ARC's data (see table No. 2) shows, railroad traffic, measured in ton-miles, increased -- going from 919 billion ton-miles in 1980 to 1.4 trillion ton-miles in 1998. With such enormous savings and constant traffic growths, why is there not enough capacity at terminals to adequately handle the traffic? Whose fault is this? Why do rail-dependent customers have to suffer? Adequate competition and, in the absence of such, effective regulation, would have gone a long way in ensuing adequate railroad service standards. This is not a matter of inadequate railroad earnings. The railroad industry has not been short of capital for many years.

Conclusion and Merger Policy Recommendations

IFPA and it members endorse many of the recommendations put forth by the Alliance for Rail Competition.

Freight railroads are a national asset which have the ability to provide relatively low-cost, energy-efficient, and environmentally benign transportation service. Further, these railroads have a duty to serve all of their customers, without whom railroads would cease to exist. The best means for ensuring the railroad industry's viability is to encourage rail carriers to compete among themselves, as well as with other modes of transportation. Competition is the engine that drives the free enterprise system. It pressures suppliers (railroads) to be efficient and can help railroads grow traffic.

The Net Impact On Customers Should Be The Key Merger Criterion

Railroad mergers should not be approved if the prospective cost reductions are offset by adverse impacts on railroad customers due to a diminishment of competition.

Competitive Access Is the Preferred Protection For Customers

Competitive access is preferable to regulation because it motivates carriers to be responsive to customer needs. Competitive access would benefit railroads in that the incumbents: (1) could charge adequate user fees, (2) would experience traffic growth, and (3) would in turn realize newly-found economies of traffic density.

Railroad Customers Need Safe Harbor Protection

In the absence of effective railroad competition, economic regulation is necessary to insure that service is adequate and freight rates are reasonable. Opening access and economic regulation is not an either-or choice; they are parts of a whole.

Railroad Mergers Are Not the Only Way to Lower Operating Costs

Traffic growth is a key to economies of railroad track density. Aside from traffic growth, railroads can reduce costs through a wide variety of managerial and technological means. Railroads have controlled their costs by eliminating inefficient service, reducing crew sizes, changing operating and work rules, and employing new technology.

Post-Merger Performance Must Be Closely Monitored

The STB shall establish procedures to measure post-merger performance and issue an annual report of its findings for a period of ten years.

Table No. 1
DECLINING RAILROAD OPERATING EXPENSES
(Class I Railroads)

Year	Railroad Operating Expense Per Ton-Mile	Inflation (1998 = 100)	"Real" Expense Per Ton-Mile
1939	0.104 cents	3.2	0.32 cents
1980	2.75	51.7	5.32
1985	2.74[i]	67.9	4.04
1990	2.37	81.4	2.91
1995	1.99[ii]	93.4	2.13
1998	1.98[iii]	100.0	1.98

1. 2.85 cents adjusted for $809 million of special charges taken as operating expenses.
2. 2.12 cents adjusted for $1.7 billion of special charges taken as operating expenses.
3. 2.02 cents adjusted for $520 million of special charges taken as operating expenses.

Data Source: Alliance for Rail Competition

Table No. 2
INCREASING RAILROAD TRAFFIC
(Class I Railroads)

Year	Revenue Tons Originated (Millions)	Ton-Miles (Billions)
1929	1,339	447
1955	1,396	624
1970	1,484	765
1980	1,492	919
1985	1,320	877
1990	1,425	1,034
1995	1,550	1,306
1998	1,649	1,377

Data Source: Alliance for Rail Competition